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INFORMATION

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DRAFT LEGISLATION ISSUED ON TRUSTS AND THEIR BENEFICIARIES

The Honourable Michael Wilson, Minister of Finance, today released draft legislation containing proposed changes to the special rules in the Income Tax Act applicable to trusts and their beneficiaries.

These changes are intended to simplify the provisions of the Act applicable to trusts and to remove certain deficiencies in their application to inter-vivos trusts -- that is, trusts other than testamentary trusts.

The Minister noted that there are serious shortcomings in the existing rules applicable to trusts which carry on business in Canada or have income from Canadian real estate, resource properties and timber resource properties and from dispositions of taxable Canadian property (such income is referred to as "designated income") for the benefit of non-resident beneficiaries. The changes seek to overcome these deficiencies. The principal change is the introduction of a special tax of 36 per cent on distributions by trusts out of designated income. The special tax will be deductible in computing the income of the trust for Part I purposes. Resident beneficiaries of trusts which have paid the tax will be entitled to obtain credit for their share of the tax so paid. The new tax will not apply to testamentary trusts, mutual fund trusts or trusts that are exempt from tax under Part I.

The new tax will also apply where a taxable trust makes distributions out of its designated income to persons who are exempt from tax under Part I where they acquire their interests in such trusts directly or indirectly

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Canada

from other beneficiaries of the trust after October 1, 1987. This change is intended to prevent income which has accrued in the trust for the benefit of a taxable beneficiary from escaping tax where the interest is transferred to a person who is not taxable.

The Minister also noted that the increasing use of trusts in commercial arrangements has emphasized the need for several other amendments to the Act, including changes to the special rules which were intended for testamentary and family trusts in which none of the interests was purchased from the trust or a settlor of the trust. These changes include:

-- withdrawing the rules that allow a trust to allocate capital cost allowances and depletion to beneficiaries,

-- restricting the preferential flow-through of trust income and the character of certain of its sources to trusts that are resident in Canada,

-- permitting a trust, in computing its income, to deduct an amount in respect of its income distributions to beneficiaries which is less than the amount of the actual distributions,

-- amending the adjusted cost base rules to require amounts received from the trust to reduce the adjusted cost base of the beneficiary's interest in the trust except to the extent such amounts are included in the beneficiary's income,

-- limiting the preferential treatment accorded dispositions of capital interests to interests in testamentary and family trusts, and

-- excluding from the "21 year" deemed disposition rule, those trusts under which all beneficiaries' rights are vested indefeasibly in possession.

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The Minister indicated that these basically technical changes would, after a period of consultation, be contained in ways and means motions effective for taxation years of trusts commencing after 1987. The Minister requested that any suggestions or comments on the proposed changes be directed to the Tax Policy and Legislation Branch of the Department as soon as possible.

For further information, please contact:

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Introductory Overview - Commercial Trusts and Their Beneficiaries

Designated Income Rules

Under the existing rules, the income distributions of a trust resident in Canada are deductible in computing trust income, except where the beneficiary is a "designated beneficiary" -- a non-resident person, non-resident-owned investment corporation and certain trusts -- and the distribution is out of the trust's "designated income"-- that is, income from carrying on business in Canada, from Canadian real estate, resource properties and timber resource properties and from dispositions of taxable Canadian property. These designated income rules were intended to ensure that certain Canadian-source income when earned by trusts for the benefit of non-residents would be subjected to Canadian tax at Part I rates rather than at the lower Part XIII rates.

The proposed changes to the designated income rules address the concern that arises where these rules apply to a trust that has resident as well as non-resident beneficiaries and, under the terms of the trust, the tax -- which is computed by reference to the distributions to non-residents -- is borne by all of the beneficiaries of the trust. Resident beneficiaries who indirectly bear a portion of the tax are not entitled to any credit for such tax and must report the full amount of their share of the trust income distributions. As proposed, the new tax (Part XII.2) will be determined by reference to all income distributions out of the designated income of a trust that makes distributions to non-resident beneficiaries, with a proportionate tax credit available for resident beneficiaries. Testamentary trusts will be exempted from the new tax since their inclusion may create hardship for such trusts. Mutual fund trusts and trusts exempt from tax under Part I, which are exempted under the existing designated income rules, will similarly be exempted from the new tax.

Under new Part XII.2, non-residents who receive designated income through a trust will effectively pay a 52 per cent tax on their share of the trust income which would otherwise have been payable to beneficiaries: 36 per

cent under new Part XII.2 plus 25 per cent on the balance distributed under Part XIII. This will be subject to a reduction to 45.6 per cent where the Part XIII rate is reduced to 15 per cent by tax convention or treaty.

In addition, the new tax will apply where persons exempt from tax under Part I receive distributions out of the designated income of a taxable trust and where such persons have acquired their interests in the trust from other beneficiaries. This will prevent certain income which has accrued in the trust for the benefit of taxable beneficiaries from escaping from Part I tax or its equivalent. The new tax will not apply in respect of such distributions where the trust interests were acquired before October 2, 1987.

Income Flow-Through Rules

Under the existing rules, the income of a trust for a taxation year -- determined in accordance with the provisions of Part I of the Act but before deducting any amount in respect of capital cost allowance or terminal loss -- that becomes payable in the year to the beneficiaries of the trust is normally taxable in the hands of the beneficiaries. If the trust would otherwise be entitled to claim capital cost allowance or depletion allowance in computing its income for the year, the existing rules permit beneficiaries under the trust to deduct their shares of such allowances against the trust income which has become payable to them. Under these rules, a trust may be unable to deduct its losses from a prior year if, in accordance with the terms of the trust, all trust income is required to be distributed to the beneficiaries under the trust. This results from the mandatory deduction of trust income distributions under the existing rules.

Under the proposals, the income distributions of a trust will only be taxable in the beneficiary's hands to the extent of the trust's income otherwise determined under Part I -- after deducting capital cost allowance and terminal loss amounts -- and to the extent the trust deducts such amounts in computing its income. These changes allow for the repeal of the rules dealing with the trust allocations of capital cost allowance and depletion allowance and will generally resolve the problem for trusts in utilizing loss carry-forwards.

Under the proposals, the rules providing for the flow-through of the trust income and certain of its sources will be restricted to beneficiaries of resident trusts. Beneficiaries of non-resident trusts will include in their income all distributions which they become entitled to receive from the trust other than distributions or payments of capital by a testamentary trust or an inter-vivos trust in which none of the interests has been purchased from the trust or a settlor thereof.

Adjusted Cost Base Rules

Under the existing rules, certain amounts distributed by a trust to its beneficiaries out of trust income may be neither taxable in their hands nor regarded as payments of capital. Such amounts may not reduce the adjusted cost base of the capital interests of the beneficiaries under the trust.

Under the proposals, the rules governing the computation of the adjusted cost base of a capital interest in a trust will be revised to require that all trust distributions other than amounts which are required to be included in income by the beneficiaries will reduce the beneficiary's adjusted cost base. An exception to this rule will permit a resident trust to distribute in a year the non-taxable portion of its capital gains for the year without causing a reduction in the adjusted cost base of its capital interests. These rules will not apply in respect of capital interests in testamentary trusts or inter-vivos trusts in which none of the interests is purchased from the trust or a settlor of the trust, unless such interest has been purchased by the beneficiary.

Capital Interest Rules

Under the existing rules, beneficiaries under commercial trusts, other than unit trusts, are entitled to the benefits of the special rules that apply on the disposition of capital interests in the trust. These rules provide that, where the trust property is distributed to the beneficiary in satisfaction of his rights as a capital beneficiary, the property may be rolled over to the beneficiary at its cost amount to the trust. In addition, on the disposition of a capital interest, the capital gain that

would otherwise occur may be reduced where the cost amount of the trust property attributable to the interest is greater than the beneficiary's adjusted cost base.

Under the proposals, these rules would be limited in their application to testamentary trusts and inter-vivos trusts in which none of the interests has been purchased from the trust or a settlor of the trust.

Deemed Disposition Rules

Under the existing rules, the capital properties, land inventories and resource properties owned by trusts -- other than unit trusts and trusts governed by certain deferred income plans -- are deemed to have been disposed of and subsequently reacquired by the trust on certain dates. In the case of commercial trusts other than unit trusts, the first application of this rule would occur on January 1, 1993. This rule was intended to prevent the use of trusts in estate planning arrangements to defer indefinitely the recognition of capital gains which would otherwise occur on the death of the individual or on his ceasing to reside in Canada.

It is proposed to exclude from the deemed disposition rules those trusts in which every interest in the trust is vested absolutely in possession in the holder thereof or which will so vest upon the death of the settlor or his spouse (or former spouse). Such trust arrangements do not permit the deferral of capital gains beyond the lifetime of the holders of such vested interests.

DRAFT AMENDMENTS
TRUSTS AND BENEFICIARIES

1.(1) Subsection 52(6) of the Income Tax Act is repealed and the following substituted therefor:

Cost of right to receive from trust

"(6) Notwithstanding subsection (1), where a beneficiary under a trust acquires a right to enforce payment by the trust of an amount out of a capital gain or the income of the trust (determined without reference to the provisions of this Act) for the taxation year of the trust in which the right was acquired by him, for the purposes of this subdivision, the cost of the right so acquired shall be deemed to be the amount that became so payable."

(2) Subsection (1) is applicable with respect to rights acquired in a trust in the 1988 and subsequent taxation years of the trust.

2.(1) All that portion of paragraph 53(2)(h) of the said Act preceding subparagraph (ii) thereof is repealed and the following substituted therefor:

"(h) where the property is a capital interest of the taxpayer in a trust (other than an interest acquired by the taxpayer for no consideration in a testamentary trust or in a trust no beneficial interest in which was acquired for consideration payable directly or indirectly to the trust or to any person who has made a contribution to the trust by way of transfer, assignment or other disposition of property),

(i) any amount paid to the taxpayer by the trust after 1971 and before that time on a distribution or payment of capital by the trust (otherwise than as proceeds of disposition of the interest or part thereof), to the extent that such amount became payable before 1988,

(i.1) any amount that has become payable to the taxpayer by the trust after 1987 and before that time in respect of the interest (otherwise than as proceeds of disposition of the interest or part thereof), except to the extent of the portion thereof

(A) that has been included in the taxpayer's income by reason of subsection 104(13) or from which an amount of tax has been deducted under Part XIII by reason of paragraph 212(1)(c), or

(B) where the trust was resident in Canada throughout its taxation year in which the amount became payable, that may reasonably be considered to be out of the non-taxable portion of a capital gain of the trust for the year (but not exceeding an amount equal to 1/2 of the amount designated by the

trust for the purposes of subsection 104(21) in respect of the taxpayer for the year) and that was designated by the trust in its return of income for the year in respect of the taxpayer and not in respect of any other beneficiary under the trust,"

(2) Subsection (1) is applicable with respect to amounts that become payable by trusts after 1987, except that subparagraph 53(2)(h)(i.1), as enacted by subsection (1), shall not apply with respect to that portion of an amount that becomes payable by a trust created before October 2, 1987 (other than a unit trust) in a taxation year of the trust ending before 1990 to a taxpayer, that may reasonably be considered to be out of an amount that has been deducted in computing the income of the trust for the year under subsection 20(16) of the said Act or under regulations made under paragraph 20(1)(a) or subsection 65(1) of the said Act, where

(a) such portion is designated by the trust in respect of the taxpayer and not in respect of any other beneficiary under the trust and does not exceed the proportion of the aggregate of amounts that the trust so designates for all beneficiaries in respect of the year, that

(i) the taxpayer's share of the income of the trust for the year computed without reference to this Act

is of

(ii) the income of the trust for the year computed without reference to this Act,

(b) no beneficial interest in the trust is created before the end of the year and after October 1, 1987 (other than pursuant to the terms of a prospectus, preliminary prospectus, registration statement, offering memorandum or notice filed before October 2, 1987 with a public authority in Canada, where such document was required by law to be so filed before trading in the securities can commence, and

(c) there has not been a substantial increase in the indebtedness of the trust before the end of the year and after October 1, 1987 (other than as a consequence of an agreement in writing entered into before October 2, 1987).

3.(1) Section 104 of the said Act is amended by adding thereto, immediately after subsection (5.2) thereof, the following subsection:

Application of subsections (4), (5) and (5.2)

"(5.3) Subsections (4), (5) and (5.2) do not apply in respect of a trust (other than a trust described in paragraph 104(4)(a)), the terms of which provide that

(a) every interest that has or may be created under the trust is vested indefeasibly in possession upon creation, or

(b) every interest under the trust is to be vested indefeasibly in possession prior to, upon or as a consequence of the death of the settlor of the trust or the spouse or former spouse of the settlor."

(2) Paragraph 104(6)(b) of the said Act is repealed and the following substituted therefor:

"(b) in any other case, such amount as the trust may claim not exceeding such part of the amount that, but for this subsection, subsection (12) and, where the trust is a trust described in paragraph (4)(a), subsections (4), (5), (5.2) and 107(4), would be its income for the year as became payable in the year to a beneficiary or was included in computing the income of a beneficiary for the year by reason of subsection 105(2)."

(3) Section 104(7) of the said Act is repealed and the following substituted therefor:

Non-resident beneficiary

"(7) No deduction may be made under subsection (6) in computing the income for a taxation year of a trust in respect of such part of an amount that would otherwise be its income for the year as became payable in the year to a non-resident person or to a partnership (other than a Canadian partnership within the meaning assigned by section 102) unless, throughout the year, the trust was resident in Canada."

(4) Subsection 104(8) of the said Act is repealed.

(5) Subsection 104(13) of the said Act is repealed and the following substituted therefor:

Income of beneficiary

"(13) There shall be included in computing the income for a taxation year of a beneficiary under a trust such of the following amounts as are applicable:

(a) in the case of a trust (other than a trust referred to in subparagraph 108(1)(j)(ii)) that was resident in Canada throughout its particular taxation year that ended in the year, such part of the amount that, but for subsections (6) and (12), would be the trust's income for the particular year as became payable in the particular year to the beneficiary,

(b) in the case of a trust governed by an employee benefit plan to which the beneficiary has contributed as an employer, such part of the amount that, but for subsections (6) and

(12), would be the income of the trust for its particular taxation year that ended in the year as was paid in the particular year to the beneficiary, and

(c) in the case of a trust (other than a trust referred to in paragraph (a) or subparagraph 108(1)(j)(ii)), all amounts that became payable in the year by the trust to the beneficiary in respect of his interest in the trust, otherwise than

(i) as proceeds of disposition of the beneficiary's interest or part thereof, or

(ii) on a distribution or payment of capital by a testamentary trust or a trust no beneficial interest in which was acquired for consideration payable directly or indirectly to the trust or to any person who has made a contribution to the trust by way of transfer, assignment or other disposition of property."

(6) Section 104 of the said Act is further amended by adding thereto, immediately after subsection (13), the following subsection:

Amounts deemed not paid

"(13.1) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada, designates an amount in respect of a beneficiary under the trust, not exceeding the amount determined by the formula

$$\frac{A}{B} \times (C - D)$$

where

A is the beneficiary's share of the income of the trust for the year computed without reference to this Act,

B is the aggregate of all amounts each of which is a beneficiary's share of the income of the trust for the year computed without reference to this Act,

C is the aggregate of all amounts each of which is an amount that, but for this subsection, would be included in computing the income of a beneficiary under the trust by reason of subsection (13) or 105(2) in respect of the year, and

D is the amount deducted in accordance with subsection (6) in computing the income of the trust for the year,

the amount so designated shall be deemed, for the purposes of subsections (13) and 105(2), not to have been paid or payable in the year to or for the benefit of the beneficiary or out of the income of the trust."

(7) Subsections 104(16), (17), (17.1) and (17.2) of the said Act are repealed.

(8) All that portion of subsection 104(19) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

Taxable dividends

"(19) Such portion of the aggregate of taxable dividends received by a trust in a taxation year throughout which it was resident in Canada on shares of the capital stock of a taxable Canadian corporation as"

(9) Subsection 104(20) of the said Act is repealed.

(10) All that portion of subsection 104(21) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

Taxable capital gains

"(21) Such portion of the net taxable capital gains of a trust for a taxation year throughout which it was resident in Canada as"

(11) Subsection 104(21.1) of the said Act is repealed.

(12) All that portion of paragraph 104(22)(a) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"(a) such portion of the income of a trust for a taxation year throughout which it was resident in Canada (before making any deduction under subsection (6) or (12)) from sources in a foreign country as"

(13) Subsection 104(24) of the said Act is repealed and the following substituted therefor:

Amount payable

"(24) For the purposes of subparagraph 53(2)(h)(i.1) and subsections (6), (7) and (13), an amount shall be deemed not to have become payable by a trust in a taxation year unless it was paid by the trust in the year to a person to whom it was payable or the person was entitled in the year to enforce payment thereof."

(14) Subsections 104(25) and (25.1) of the said Act are repealed.

(15) All that portion of subsection 104(27) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

Part of income included in beneficiary's income

"(27) Such portion of any amount that would otherwise be included under subparagraph 56(1)(a)(i) in computing the income of a testamentary trust for a taxation year throughout which it was resident in Canada"

(16) All that portion of subsection 104(29) of the said Act preceding paragraph (a) thereof is repealed and the following substituted therefor:

Amounts deemed payable to beneficiaries

"(29) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada, designates an amount not exceeded the proportion of the amount, if any, by which"

(17) Section 104 of the said Act is further amended by adding thereto the following subsections:

Tax under Part XII.2

"(30) For the purposes of this Part, there shall be deducted in computing the income of a trust for a taxation year the tax payable by the trust for the year under Part XII.2.

Idem

(31) The amount in respect of a taxation year of a trust that is deemed under subsection 211(2) to have been paid by a beneficiary under the trust on account of his tax under this Part shall, for the purposes of subsection (13), be deemed to be an amount in respect of the income of the trust for the year that has become payable by the trust to the beneficiary in the year."

(18) Subsections (1) to (3) and (6) to (17) are applicable to taxation years of trusts commencing after 1987.

(19) Subsection (4) is applicable to the 1988 and subsequent taxation years.

(20) Subsection (5) is applicable with respect to amounts that become payable in taxation years of trusts commencing after 1987.

4.(1) Subsection 105(1) of the said Act is repealed and the following substituted therefor:

Benefits under trust

"105.(1) The value of all benefits to a taxpayer during a taxation year from or under a trust, irrespective of when created, shall be included in computing his income for the year except to the extent that the value

(a) has otherwise been included in computing his income for the year or a preceding taxation year; or

(b) has been deducted under paragraph 53(2)(h) in computing the adjusted cost base of his interest in the trust or would be so deducted if that paragraph

(i) applied in respect of the taxpayer's interest in the trust, and

(ii) were read without reference to clause (i.1)(B) thereof,"

(2) Subsection (1) is applicable with respect to benefits received from trusts in taxation years of the trusts commencing after 1987.

5.(1) All that portion of subsection 107(2) preceding paragraph (a) thereof is repealed and the following substituted therefor:

Distribution of capital interest

"(2) Where at any time any property of a testamentary trust or of a trust no beneficial interest in which was acquired for consideration payable directly or indirectly to the trust or to any person who has made a contribution to the trust by way of transfer, assignment or other disposition of property has been distributed by the trust to a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of his capital interest in the trust, the following rules apply:"

(2) All that portion of subsection 107(5) preceding paragraph (a) thereof is repealed and the following substituted therefor:

Distribution to non-resident

"(5) Where subsection (2) is applicable in respect of the distribution by a trust of any property (other than a Canadian resource property or property that is or would, if at no time in the taxation year of the trust in which it was so distributed the trust had been resident in Canada, be taxable Canadian property) to a non-resident taxpayer or a partnership (other than a Canadian partnership within the meaning assigned by section 102) which was a beneficiary under trust, notwithstanding paragraphs (2)(a) to (c), the following rules apply:"

(3) Section 107 of the said Act is further amended by adding thereto, immediately after subsection (5) thereof, the following subsection

Other distributions

"(5.1) Where at any time any property of a trust has been distributed by the trust to a beneficiary under the trust in satisfaction of all or any part of his capital interest in the trust and subsection (2) is not applicable in respect of the distribution, the following rules apply:

(a) the trust shall be deemed to have disposed of the property for proceeds equal to its fair market value at that time;

(b) the beneficiary shall be deemed to have acquired the property at a cost equal to that fair market value; and

(c) the beneficiary shall be deemed to have disposed of all or part, as the case may be, of his interest in the trust for proceeds of disposition equal to the cost at which he is deemed by paragraph (b) to have acquired the property."

(4) Subsections (1) to (3) are applicable with respect to distribution of properties by trusts in taxation years of the trusts commencing after 1987.

6.(1) Paragraph 108(1)(a) of the said Act is repealed and the following substituted therefor:

"accumulating income"

"(a) "accumulating income" of a trust for a taxation year means the amount that would, but for subsection 104(12) and, where the trust is a trust described in paragraph 104(4)(a), subsections 104(4), (5), (5.2) and 107(4), be its income for the year;"

(2) All that portion of paragraph 108(1)(d) of the said Act preceding subparagraph (i) thereof is repealed and the following substituted therefor:

"cost amount"

"(d) notwithstanding the definition "cost amount" in subsection 248(1), "cost amount" of a capital interest or part thereof, as the case may be, of a taxpayer at any time in a trust referred to in subparagraph (c)(i) (other than a trust that is a foreign affiliate of the taxpayer) means,"

(3) Paragraph 108(1)(d.1) of the said Act is repealed.

(4) All that portion of paragraph 108(1)(j) the said Act preceding subparagraph (ii) thereof is repealed and the following substituted therefor:

"trust"

"(j) "trust" includes an inter-vivos trust and a testamentary trust but, in subsections 104(4), (5), (5.2), (12) (14) and (15) and sections 105 to 107, does not include"

(5) Subsections (1) and (4) are applicable to taxation years of trusts commencing after 1987.

(6) Subsections (2) and (3) are applicable after 1987.

7.(1) The said Act is amended by adding thereto, immediately after section 209 thereof, the following Part:

"Part XII.2
Tax on Designated Income of Certain Trusts"

Definitions

210. In this Part,

"designated beneficiary"
«bénéficiaire étranger ou assimilé»

"designated beneficiary" under a trust at any time means a beneficiary under the trust that was, at that time,

(a) a non-resident person,

(b) a non-resident-owned investment corporation,

(c) a person exempt from tax under Part I by reason of subsection 149(1), where such person acquired an interest in the trust after October 1, 1987 directly or indirectly from a beneficiary under the trust,

(d) a trust resident in Canada (other than a testamentary trust or a trust exempt from tax under Part I by reason of subsection 149(1)), if

(i) a person described in paragraph (a) or (b) or (c),

(ii) a partnership described in paragraph (e) or

(iii) a trust (other than a trust resident in Canada that is a testamentary trust)

is, at that time, a beneficiary thereunder, or

(e) a partnership, if a person described in paragraph (a), (b) or (d), a partnership or a person exempt from tax under Part I by reason of subsection 149(1) is, at that time, a member thereof;

"designated income"
«revenu de distribution»

"designated income" of a trust for a taxation year means the amount that, but for subsections 104(6), (12) and (30), would be the income of the trust for the year determined under section 3 if

(a) it had no income other than incomes from

(i) real properties in Canada (other than Canadian resource properties),

(ii) timber resource properties,

(iii) Canadian resource properties (other than properties acquired by the trust before 1972), and

(iv) businesses carried on in Canada,

and taxable capital gains;

(b) the only taxable capital gains and allowable capital losses referred to in paragraph 3(b) were from dispositions of property that would have been taxable Canadian property if, at no time in the year, the trust had been resident in Canada; and

(c) the only losses referred to in paragraph 3(d) were losses from sources described in subparagraphs (a)(i) to (iv);

Application of Part

210.1 This Part does not apply in a taxation year to a trust that was throughout the year

(a) a testamentary trust,

(b) a mutual fund trust, or

(c) a trust that was exempt from tax under Part I by reason of subsection 149(1).

Tax on income of trust

211.(1) Where an amount in respect of the income of a trust for a taxation year is or would, if Part I were applicable, be included in computing the income under Part I of a person by reason of subsection 104(13) or 105(2), the trust shall pay a tax under this Part in respect of the year equal to the lesser of

(a) 36% of the designated income of the trust for the year, and

(b) 36/64 of the amount deducted under paragraph 104(6)(b) in computing the trust's income under Part I for the year.

Tax deemed paid by beneficiary

(2) Where an amount (in this subsection referred to as the "income amount") in respect of the income of a trust for a taxation year is, by reason of subsection 104(13) or 105(2), included in computing the income under Part I of a person who was not at any time during the year a designated beneficiary under the trust, an amount determined by the formula

$$A \times \frac{B}{C}$$

where

A is the tax paid under this Part by the trust for the year,

B is the income amount in respect of the person, and

C is the aggregate of all amounts each of which is an amount that is or would be, if Part I were applicable, included in computing the income under Part I of a beneficiary under the trust by reason of subsection 104(13) or 105(2) in respect of the year,

shall, if designated by the trust in respect of the person in its return for the year under this Part, be deemed to be an amount paid on account of the person's tax payable under Part I for his taxation year in which the taxation year of the trust ends.

Designations in respect of partnerships

(3) Where the person in respect of whom an amount is designated by a trust under subsection (2) is a partnership, the amount so designated shall be deemed to be an amount paid on account of the tax payable under Part I of each person who is a member of the partnership to the extent of that person's share of the income of the partnership for its taxation year in which the taxation year of the trust ends.

Partnerships

(4) For the purposes of subsections (1), (2) and (3), a partnership shall be deemed to be a person subject to tax under Part I and its taxation year shall be deemed to be its fiscal period.

Returns

(5) A trust shall, within 3 months after the end of each taxation year,

(a) file with the Minister a return for the year under this Part in prescribed form and containing prescribed information, without notice or demand therefor;

(b) estimate in the return the amount of tax, if any, payable by him under this Part for the year; and

(c) pay to the Receiver General the tax, if any, payable by him under this Part for the year.

Liability of trustee

(6) A trustee of a trust is personally liable to pay to the Receiver General on behalf of the trust the full amount of any tax payable by the trust under this Part to the extent such amount is not paid to the Receiver General within the time specified in subsection (5), and the trustee is entitled to recover from the trust any such amount paid by him.

Provisions applicable to Part

(7) Subsections 150(2) and (3), sections 152 and 158, subsections 161(1) and (11), sections 162 to 167 and Division J of Part I are applicable to this Part with such modifications as the circumstances require.

Where no designated beneficiaries

211.1 No tax is payable under this Part by a trust for a taxation year in respect of which the trustee has certified in the return under this Part of the trust for the year that no part of the income of the trust for the year is or would be, if Part I were applicable, included in computing the income of a beneficiary under the trust who was at any time in the year a designated beneficiary."

(2) Subsection (1) is applicable to the 1988 and subsequent taxation years

9.(1) Paragraph 212(1)(c) of the said Act is repealed and the following substituted therefor:

Estate or trust income

"(c) income of or from an estate or trust <u>to the extent that such amount would, if Part I were applicable, be included in computing the income of the non-resident person by reason of</u>

subsection 104(13), except to the extent that such amount is deemed by subsection 104(21) to be a taxable capital gain of the non-resident person."

(2) Subsections 212(11.1) and (11.2) of the said Act are repealed.

(3) Subsections (1) and (2) are applicable to the 1988 and subsequent taxation years.

EXPLANATORY NOTES

ITA 52(6)

Cost of Right
Received From
Trust

Subsection 52(6) of the Act provides that a beneficiary's right to enforce payment of an amount out of the capital gains or income from property of a unit trust for the year in which the beneficiary acquired the right is considered to have a cost equal to such amount. This ensures that the non-taxable portion of a unit trust's capital gains as well as capital dividends received by the trust can be distributed to beneficiaries without giving rise to capital gains in their hands on the disposition of the right. This subsection also provides that the beneficiary's cost of the right is reduced by amounts of capital cost allowance and depletion that is allocated by the trust to the beneficiary.

The amendment to subsection 52(6) will extend the application of this provision to beneficiaries under all trusts. In addition, as a consequence of the proposed repeal of the rules permitting a trust to allocate capital cost allowance and depletion to its beneficiaries described below, the references in subsection 52(6) to subsections 65(1) and 104(16) are being repealed.

ITA 53(2)(h)

Adjusted Cost Base
of Trust Interest

Paragraph 53(2)(h) of the Act requires certain amounts to be deducted in computing the adjusted cost base of a unit of a unit trust or of a capital interest in any other trust that was purchased by the taxpayer.

Paragraph 53(2)(h) is being amended in light of the change proposed in Bill C-64 to the definition of capital interest in a trust and in order to provide consistent treatment in respect all interests in commercial trusts - trusts which are neither testamentary trusts nor inter-vivos trusts of the type typically established for family reasons--that is, an inter-vivos trust in which none of the interests was purchased from the trust or a settlor thereof. Such inter-vivos trusts are referred to in these notes as "family trusts". In addition, paragraph 53(2)(h) will continue to apply in respect of purchased interests in testamentary and family trusts.

New subparagraph 53(2)(h)(i.1) will ensure that all distributions by a trust to a beneficiary will reduce the adjusted cost base of the beneficiary's capital interest, unless the amount represents proceeds of disposition of the interest or is included in the beneficiary's income. Thus, distributions out of a trust's income as determined for trust purposes, in excess of its income for tax purposes, will reduce the adjusted cost base of the beneficiaries' capital interests. This will

also occur where distributions to beneficiaries out of the income for tax purposes of the trust are not fully deducted by the trust as permitted under the proposed amendment to subsection 104(6).

New subparagraph 53(2)(h)(i.1) provides a special exception to the general rule described above to permit the non-taxable portion of capital gains realized by a resident trust in a year to be distributed to beneficiaries in that year with no reduction in the adjusted cost base of their capital interests in the trust. For this purpose, the non-taxable portion of the capital gains of a trust is determined by reference to the portion of net taxable capital gains designated by the trust in respect of a beneficiary pursuant to subsection 104(21). In no event can the non-taxable portion exceed 1/2 of the amount so designated. This maximum assumes the two-thirds inclusion rate for 1988 as proposed in the White Paper on Tax Reform and will be altered to reflect changes in the capital gains inclusion rates in future years.

Subject to a special transitional rule, this new subparagraph will apply with respect to all amounts that become payable by a trust after 1987. However, in the case of a trust that is not a unit trust and that was created before October 2, 1987, it will not apply to amounts that become payable in taxation years of the trust ending before 1990 and that may reasonably be considered to be out of capital cost allowance, terminal losses or depletion deducted by the trust for the year. To qualify for this transitional relief, such amounts must be designated by the trust in its return of income for the year in accordance with the coming-into-force provision. This transitional rule will cease to apply if the trust creates any new beneficial interest after October 1, 1987, other than pursuant to the terms of a prospectus, preliminary prospectus, registration statement, offering memorandum or notice filed with a public authority in Canada (where such filing is required before trading can commence) or if there is a substantial increase in the indebtedness of the trust other than as a consequence of an agreement in writing entered into before October 2, 1987.

ITA 104(5.3)

Deemed Disposition
of Trust Property

Subsection 104(4) and related subsections 104(5) and (5.2) of the Act set out what is generally referred to as the "21-year deemed realization" rule for trusts. The purpose of the rule is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital properties, resource properties and land inventories. These subsections generally treat such properties as having been disposed of and reacquired by most trusts every 21 years at their fair market value. However, this rule does not apply to exempt trusts, unit trusts and certain spousal trusts.

New subsection (5.3) introduces two further exceptions to this rule.

The first exception is for the type of trust in which all interests are vested indefeasibly in possession. Under such a trust, all beneficiaries have an absolute present right to receive the income and capital of the trust and such rights may not be modified or terminated on the beneficiary's death or any other event. This exception will generally exclude commercial trusts, which are currently subject to the deemed realization rule unless they qualify as unit trusts.

The second exception is for those trusts which provide that before, upon or as a consequence of the death of the settlor or the spouse (or former spouse) of the settlor, all of the interests under the trust will be vested indefeasibly in possession. Thus, for example, a trust for the children of a settlor under which they may receive income only during the settlor's lifetime would qualify for this exemption if, under the terms of the trust, the children who are alive at the settlor's death will acquire present rights to receive all of the capital of the trust at that time. This exclusion recognizes that such trust arrangements are not designed to obtain unlimited gains deferrals.

ITA 104(6)

Deduction in Computing
Trust Income

Subsection 104(6) of the Act provides that a trust may deduct, in computing its income, amounts that become payable or are paid out of the trust income to or for the benefit of beneficiaries. Under the existing rules, the maximum amount that may be deducted under subsection 104(6) is the trust income determined under Part I, before deducting distributions to beneficiaries and allocations to preferred beneficiaries. However, a deduction is not allowed to permit a spousal trust to reduce its income below the amount included in its income by reason of the deemed dispositions of certain properties pursuant to subsections 104(4) and (5). This rule does not similarly restrict the deduction in respect of income arising on the deemed disposition of resource properties.

The amendment to paragraph 104(6)(b) corrects this deficiency by adding a reference to subsection 104(5.2). This reference is strictly consequential on the introduction of that provision in 1985.

In addition, paragraph 104(6)(b) is amended to permit the deduction, at the discretion of the trust, of an amount that is less than the amount of its income distributions. To the extent such distributions are not deducted by the trust, they will not be taxable in hands of the beneficiaries provided the requirements of new subsection 104(13.1) are met. This change will enable trusts to utilize in a particular year losses from prior years without affecting the ability of the trust to distribute its income currently. Distributions of income in excess of the amount deducted by the trust will, however, reduce the adjusted cost base of the beneficiary's capital interest in the trust. (See comments on the amendments to paragraph 53(2)(h).)

ITA 104(7)

Non-resident Beneficiary

Subsection 104(7) of the Act denies the deduction under subsection 104(6) to a trust of income distributions to non-resident beneficiaries unless the trust is resident in Canada.

Under the proposed changes, subsection 104(7) will also apply to deny the deduction of trust income distributions to partnerships unless all the partners are Canadian residents. In addition, the new subsection will require that a trust be resident in Canada throughout the year in order to obtain subsection 104(6) deductions in respect of its income distributions to non-resident beneficiaries.

ITA 104(8)

Limitation on
Deduction
Under 104(6)

Subsection 104(8) of the Act provides a special rule to deny the deduction under subsection 104(6) of trust income distributions to designated beneficiaries - non-resident persons, non-resident-owned investment corporations and certain trusts - out of the income of the trust from carrying on business in Canada, from Canadian real estate, resource properties and timber limits and from dispositions of taxable Canadian property. The purpose of this special rule is to ensure that these types of income are taxable to non-resident and other designated beneficiaries at the full Part I rates rather than at the non-resident withholding tax rates. Subsection 104(8) is to be repealed as a consequence of the introduction of new Part XII.2, which is described below.

ITA 104(13)

Income Payable
to Beneficiary

Subsection 104(13) of the Act requires the inclusion of trust income distributions in the income of the beneficiaries who are entitled to receive such distributions. This inclusion corresponds to the deduction provided to the trust in respect of such distributions under subsection 104(6), except that where the trust has itself deducted amounts in respect of capital cost allowance or terminal loss in computing its income for tax purposes, the amount included in a beneficiary's income is the amount of the distribution out of the trust's income computed before any deduction for capital cost allowance or terminal loss. Under the existing provisions, while the gross amount is included in the beneficiary's income, the trust may allocate to its beneficiaries the capital cost allowance deductions to which it would otherwise have been entitled in accordance with the rules in subsections 104(16), (17.1) and (17.2), and these amounts are deductible by the beneficiary.

Two changes to subsection 104(13) are proposed. First, the special treatment which allows the capital cost allowance and terminal loss to be flowed out to beneficiaries will no longer apply. Capital cost allowances will be deductible only by the trust, and the income of the trust, determined in accordance with Part I of the Act after deducting capital cost allowance, is the maximum amount that will be taxed in the beneficiaries' hands under subsection 104(13), 104(14) or paragraph 212(1)(c). As a consequence, subsections 104(16), (17.1) and (17.2), which provide for the flow-through to beneficiaries of capital cost allowances, will no longer be appropriate and are repealed.

The second change reflected in paragraph (c) provides that all amounts that become payable to a beneficiary by a non-resident trust will be included in the beneficiary's income. However, such amounts will not include proceeds arising on the disposition of all or part of an interest in the trust or, where the trust is a testamentary or family trust, distributions of capital.

ITA 104(13.1)

Excess Amount

New subsection 104(13.1) is consequential upon the change to subsection 104(6) which permits a trust to deduct less than the full amount of its income distributions. Subsection 104(13.1) provides the mechanism for a trust to designate to its beneficiaries their respective shares of the amount by which its actual income distributions exceed the amount which it has deducted in respect of such distributions in computing its income for the year. Such designated amounts are deemed not to have been paid or payable in the year by the trust for the purposes of subsections 104(13) and 105(2), with the result that such amounts will neither be deductible to the trust nor taxable in the hands of the beneficiaries. Under revised paragraph 53(2)(h), however, such amounts will reduce the adjusted cost base to the beneficiaries of their capital interest in the trust. (See comments on the amendments to paragraph 53(2)(h).)

ITA 104(16),
104(17),
104(17.1) and
104(17.2)

Capital Cost Allowance
and Depletion Allowance
Allocations

Subsections 104(16), (17.1) and (17.2) of the Act permit a trust to allocate to its beneficiaries amounts of capital cost allowance, terminal loss and depletion allowance which the trust would otherwise be entitled to deduct in the year.

The change to subsection 104(13), described above, provides that only the trust may claim such deductions. As a consequence, subsections 104(16), (17), (17.1) and (17.2) will no longer be

appropriate and will be repealed. Under revised subsection 104(13), where a trust claims capital cost allowances, terminal losses or depletion in computing its income for tax purposes and distributes its cash flow to its beneficiaries, such distributions will only be included in the beneficiaries' incomes to the extent of the portion thereof that is out of the income of the trust for the year determined under the Act after deducting such amounts.

ITA 104(19), 104(21),
104(22), 104(27)
and 104(29)

Flow-Through of
Income Sources

The proposals clarify that the provisions which permit certain types of income to retain their character on a distribution in a year to beneficiaries are limited to those trusts which are resident in Canada throughout the year. Under these changes, the entitlement to flow-through those sources of income which benefit from preferential treatment under Part I of the Act will be limited to trusts which are taxable under Part I on their world income. The provisions affected are:

1. subsection 104(19) in respect of dividends from taxable Canadian corporations,

2. subsection 104(21) in respect of net taxable capital gains,

3. subsection 104(22) in respect of foreign source income and foreign taxes paid in respect thereof, and

4. subsection 104(27) in respect of pension benefits.

Similarly, the special treatment under subsection 104(29) for the "phantom income" of a trust - the amount of the non-deductible resource royalties of the trust - is restricted to resident trusts.

ITA 104(20)

Non-taxable Dividends

Subsection 104(20) of the Act is repealed as a consequence of the proposed revisions to subsections 104(13) and 105(1) and proposed new subsection 104(13.1). In the case of commercial trusts, distributions which are not income to the beneficiaries will reduce the adjusted cost bases of the beneficiaries' interests in the trust except to the extent that such distributions represent the non-taxable portion of capital gains, designated in accordance with proposed new subparagraph 53(2)(h)(i.1), as described above.

ITA 104(21.1)

Taxable Capital
Gains from
Canadian Securities

Subsection 104(21.1) is repealed as a consequence of the change in 1986 to section 110.1 which removed taxable capital gains from the category of income that is eligible for the $1,000 investment income deduction.

ITA 104(24)

Definition of
"Amount Payable"

The definition of "amount payable" in subsection 104(24) is relevant for the purpose of determining amounts that are deductible by a trust and included in the income of beneficiaries. This subsection is amended to make the definition applicable also for the purposes of new rules in subparagraph 53(2)(h)(i.1) relating to the computation of the adjusted cost base of a capital interest in a trust. In addition, the references to subsections 104(8), (20), (25) and 212(11.1) are deleted as a consequence of the repeal of those subsections.

ITA 104(25) and
104(25.1)

Excess Amount

Subsections 104(25) and (25.1) of the Act provide rules to ensure that the same income will not be taxed both in the trust and in the hands of its beneficiaries. These provisions are no longer required in light of the repeal of subsection 104(8), the proposed change described above to subsection 104(13) and proposed new subsection 104(13.1), which ensure that only those amounts deductible in computing a trust's income are included in the income of beneficiaries.

ITA 104(30)

Deduction for
Part XII.2
Tax Payable

As described below, new Part XII.2 provides for the payment of a special tax by trusts as part of the mechanism to replace the existing designated income rules of subsection 104(8). New subsection 104(30) provides a deduction in computing trust income for a year for this special tax. Accordingly, the tax paid under new Part XII.2 is treated in the same manner as the income distributions to which it applies. (See the example provided in the commentary on new Part XII.2.)

ITA 104(31)

Deemed Income Payable

Under new Part XII.2, certain resident beneficiaries under a trust will be entitled to a credit against their liability for tax under Part I for their share of the special Part XII.2 tax payable by the trust. New subsection 104(31) requires such beneficiaries to include in their income the amount of the credit to which they are entitled. This gross-up mechanism results in such resident beneficiaries being taxed under Part I on their share of the trust income that would, in the absence of new Part XII.2, have been distributed directly to them by the trust. (See the example provided in the commentary on new Part XII.2.)

ITA 105(1)

Benefits Under Trust

Subsection 105(1) of the Act provides that the value of all benefits received or enjoyed by a taxpayer from or under a trust - other than capital distributions - are to be included in the taxpayer's income. That subsection is amended to ensure that trust distributions which would ordinarily reduce the adjusted cost base of a beneficiary's capital interest in a trust in accordance with the amendments proposed to paragraph 53(2)(h) are excluded from the scope of subsection 105(1).

ITA 107(2)

Disposition of
Capital Interest

Subsection 107(2) of the Act provides a rollover on the distribution of trust property to beneficiaries on the termination of their interests. Thus, where trust property is distributed to a beneficiary in satisfaction of all or any part of his capital interest in the trust, subject to certain other provisions, the trust is not taxable on the distribution. In addition, the beneficiary is treated as having acquired the property at its cost amount to the trust and is treated as having received that amount as proceeds of disposition for his interest.

Subsection 107(2) is amended to limit its application to testamentary and family trusts. This change is consistent with the change to the definition of cost amount of a capital interest described below. The corresponding rules for distributions by trusts, other than testamentary and family trusts, are set out in new subsection 107(5.1), as described below.

ITA 107(5)

Distribution to
Non-Resident
Beneficiary

Subsection 107(5) of the Act provides that where trust property is distributed to a non-resident beneficiary under the trust in satisfaction of his capital interest, the rollover provisions of subsection 107(2) are not applicable unless the property is taxable Canadian property (as defined in paragraph 115(1)(b)). Rollover treatment is appropriate in the case of taxable Canadian property since any gain arising on the subsequent disposition of such property by the non-resident taxpayer will be taxable under Part I.

Subsection 107(5) is amended to exclude from the denial of such rollover treatment a distribution of Canadian resource properties to a non-resident beneficiary, since any income arising on the subsequent disposition of such properties will be subject to tax under Part I.

Subsection 107(5) is also amended to apply where trust property is distributed to a partnership, unless all of the members of the partnership are resident in Canada.

ITA 107(5.1)

Distributions by Trusts

As a consequence of the change to subsection 107(2) described above, the special rollover provided in that subsection will only apply to distributions, in trust years commencing after 1987, of trust property in satisfaction of a beneficiary's capital interest in a testamentary or family trust. New subsection 107(5.1) provides that when property is so distributed by a commercial trust, the trust is considered to have disposed of the property for proceeds equal to its fair market value at that time. In addition, the beneficiary is considered to have acquired the trust property at its fair market value and to have disposed of his interest in the trust for proceeds equal to that fair market value.

ITA 108(1)(a)

"Accumulating Income"

The definition of accumulating income is relevant for the purposes of the preferred beneficiary election provided in subsection 104(14). The amendment adds a reference to subsection 104(5.2), which is strictly consequential upon the addition in 1985 of that subsection.

ITA 108(1)(d)

"Cost Amount"

Subsection 107(1) of the Act contains special rules applicable on the disposition of a capital interest in a trust. These rules are intended to ensure that such a disposition will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount of the interest. The cost amount of a capital interest is defined for these purposes as the proportion of the cost amounts of the net assets of the trust attributable to the particular capital interest. Under the changes proposed, the definition of cost amount of a capital interest for this purpose is amended to restrict these special rules to testamentary and family trusts.

ITA 108(1)(d.1)

"Designated Income"

The definition of designated income in paragraph 108(1)(d.1) is repealed as a consequence of proposed new Part XII.2.

ITA 108(1)(j)

"Trust"

Trust is defined in paragraph 108(1)(j) so as to exclude certain types of trusts from the 21 year deemed realization rule, the preferred beneficiary election rules and the special rules in sections 105, 106 and 107. The definition is changed so that unit trusts are not excluded from the scope of these rules. Such exclusion is no longer necessary because of new subsection 104(5.3) and the changes to section 107, as described above. The addition of the reference to subsection 104(5.2) in the preamble of the definition is strictly consequential upon the addition in 1985 of that subsection.

Part XII.2 Tax on Designated Income of Certain Trusts

New Part XII.2 introduces a special tax on the designated income of certain trusts as part of the mechanism to replace the existing designated income rules of subsection 104(8). Under the existing provisions, the income distributions of a trust resident in Canada are not deductible in computing trust income where the beneficiary is a designated beneficiary -- a non-resident person, non-resident-owned investment corporation and certain trusts -- and the distribution is out of the trust's designated income -- income from carrying on business in Canada, from Canadian real estate, resource properties and timber resource properties and from dispositions of taxable Canadian property. These provisions were intended to ensure that such designated income earned by the trusts for the benefit of non-residents would be subjected to tax at full personal tax rates under Part I rather than at the lower non-resident withholding tax rates under Part XIII.

Under the existing designated income rules, where a trust has resident as well as non-resident beneficiaries, the tax under Part I resulting from the application of these rules -- which is computed by reference to the distributions to non-residents -- may, depending on the terms of the trust, be borne by all of the beneficiaries of the trust. Resident beneficiaries who indirectly bear a portion of the tax are not entitled to any credit for such tax and must report the full amount of their share of the trust income distributions. To correct this deficiency, the tax under new Part XII.2 will be determined by reference to all income distributions out of the designated income of a trust that makes income distributions, with a proportionate tax credit available for resident beneficiaries other than designated beneficiaries.

Section 210 contains definitions of "designated beneficiary" and "designated income" for the purposes of new Part XII.2. These definitions have substantially the same meaning as under the existing rules, except that the new definition of designated beneficiary includes an exempt person who acquires an interest in the trust, directly or indirectly, after October 1, 1987 from someone other than the trust.

Section 210.1 is the application section and provides that the special Part XII.2 tax does not apply to testamentary trusts, mutual fund trusts or to trusts (such as pension fund trusts or trust that are registered charities) that are exempt from tax under subsection 149(1) of the Act.

Subsection 211(1) provides that the special Part XII.2 tax in a year is generally equal to 36% of the designated income of a trust for a year, unless the amount of income distributed by a trust to its beneficiaries in the year (and deducted under paragraph 104(6)(b) in computing its income for the year) is less than 64% of the designated income of the trust for the year. In such cases, the tax is equal to 36% of the amount determined by grossing-up the amount deducted under paragraph 104(6)(b) to a before-tax amount, in recognition of the deduction under Part I for tax payable under new Part XII.2. Under section 211.1 the tax does not apply where the trustee certifies that no part of the income of the trust is distributed to designated beneficiaries as that expression is defined in section 210.

Subsection 211(2) provides the mechanism which permits a prorata portion of the tax payable under this Part to be refunded to taxable resident beneficiaries -- those beneficiaries who are not designated beneficiaries.

Subsection 211(3) provides a special rule that permits a Canadian partnership that is a beneficiary of a trust to flow out the credit for the Part XII.1 tax to its partners. Subsection 211(4) deems partnerships to be persons.

Subsections 211(5) to (7) contain provisions relating to the payment, assessment, appeal and other administrative procedures applicable to Part XII.1.

Section 211.1 provides that the Part XII.1 tax is not payable by a trust where the trustee certifies that none of the income distributions of the trust was made to designated beneficiaries.

The following example illustrates the application of new Part XII.2.

> Assume: an inter-vivos trust resident in Canada with two beneficiaries - Mr. A (a resident in Canada) and Mr. B (a non-resident) - each of whom is entitled to receive an equal share of the trust income; the income of the trust for 1988 is \$1,400 - \$1,000 of business income and \$400 of interest income.

For the trust in this example, the tax under Part XII.2 in respect of distributions out of its designated income (\$1,000 of business income) is determined under paragraph 211(1)(a). (The amount of tax determined under paragraph 211(1)(b) would only be less than the amount determined under paragraph 211(1)(a) where the trust distributed to its beneficiaries less than \$640 -- that is 64% of its designated income.) Therefore, the Part XII.2 tax payable by the trust would be \$360 (36% of \$1,000).

After determining its Part XII.2 tax liability, the trust would distribute its after-tax income of \$1,040 (\$1,400 - \$360) to its beneficiaries. One half of this amount, \$520, would be paid to Mr. A, the resident beneficiary, and the trustee would also designate \$180 of its tax to Mr. A under the formula provided in subsection 211(2) -- \$360 x 520/1,040 = \$180.

Mr. A is required to include in income \$520 under subsection 104(13) and a further \$180 under new subsection 104(31). Thus, Mr. A will include in his income a total of \$700 -- one-half of the trust income -- and will be considered to have paid tax of \$180 under Part I for his taxation year in which the trust year ends.

Mr. B will also receive \$520 from the trust. He will not receive any credit for the Part XII.2 tax paid by the trust. In addition, the non-resident withholding tax under Part XIII of the Act will be deducted from the \$520 payment at 25% or such lower rate as may be provided in a tax treaty between Canada and the country in which the taxpayer resides.

ITA 212(1)(c)

Trust Income
Payable to
Non-Residents

Under paragraph 212(1)(c) and subsection 212(11) of the Act, distributions, other than capital distributions, of a resident trust to non-resident beneficiaries, are subject to a 25% non-resident withholding tax under Part XIII. These provisions are modified by subsections 212(11.1) and (11.2), which permit the designated income of a trust to be paid free of any Part XIII tax since, under the existing rules, such income will already have borne tax under Part I.

Paragraph 212(1)(c) is revised so that a non-resident beneficiary is only subject to the Part XIII tax on amounts that would be taxable under Part I if he were resident in Canada. Thus, for example, if the designated income of a trust is \$75 after deducting \$25 of capital cost

allowance and after determining its Part XII.2 tax of $27 (36% of $75) the trust distributes $73 ($100-$27) to the non-resident beneficiary, only $48 ($75 - $27) would attract the non-resident withholding tax. As a consequence of the changes to paragraph 212(1)(c), subsections 212(11.1) and (11.2) are no longer appropriate and are accordingly repealed.